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AGENDA ITEM 5.b.

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Revision of Equity Real Estate Policy
- II. PROGRAM:** Real Estate (Core and Non Core)
- III. RECOMMENDATION:** Approve the reading and recommend to the Investment Committee approval of the Statement of Investment Policy for Equity Real Estate.
- IV. ANALYSIS:**

Background

On August 15, 2005, the Investment Committee approved a revision to the Statement of Investment Policy for Equity Real Estate expanding the Core Portfolio to include International (non U.S.) real estate investment up to a maximum limitation of 25% of the total Equity Real Estate Portfolio and up to a maximum limitation of 50% of the Core Portfolio.

Previously, the Investment Committee approved a revision to the Statement of Investment Policy for Equity Real Estate expanding the Non Core Portfolio to include International (non U.S.) real estate investment up to a maximum limitation of 15% of the total Equity Real Estate Portfolio.

Recommendation

Staff's ongoing evaluation of the global real estate investment markets and opportunity set indicates the need to revise the existing Equity Real Estate Policy. Additionally, Staff is following up to incorporate an item previously approved by the Investment Committee.

First, Staff recommends expanding the Non Core Portfolio allocation range for International investment from the current 0-15% to a proposed 0-25% of the Total Equity Real Estate Portfolio, including a limitation of 10% on Non Core international investment in any one international country as a percentage of the

Total Equity Real Estate Portfolio. Please see below for Staff's evaluation, mitigations to risk and summary of proposed revisions.

Second, Staff recommends expanding the combined allocation range for the Enhanced Core and the renamed Global (previously Extended Market) Public Real Estate Equity Securities portfolios (Enhanced Core PREES and Global PREES, respectively) from the current 0-15% to a proposed 0-25% of the total Equity Real Estate Portfolio. Staff also recommends expanding the investment universe for the Global PREES portion of the allocation to allow for international investment (non U.S.) through the engagement of external management for the international investments. Please see related agenda item 5.a. for Staff's recommendation regarding revisions to the underlying respective Statement of Investment Policy. Please also see below for Staff's summary of proposed revisions to the Equity Real Estate Policy.

Third, Staff recommends an overall maximum limitation of 50% on International investment (non U.S.) of the Total Equity Real Estate Portfolio (Core and Non Core). Please see below for Staff's summary of proposed revisions to the Equity Real Estate Policy.

Fourth, the Investment Committee at the August 15, 2005 meeting approved Staff's recommendation to allow investment in commingled funds which contain strategies to invest up to 25% of the fund in countries not included on CalPERS' Permissible Equity Markets List. Staff is following up to incorporate the approved item in the Policy. Please see below for Staff's summary of proposed revisions to the Equity Real Estate Policy.

Finally, Staff committed at the June 10, 2005 Policy Subcommittee meeting to follow up with revisions to the underlying Statement of Investment Policy for International Equity Real Estate. As the Board's Consultant, Pension Consulting Alliance (PCA), correctly notes in the attached concurrence letter, the international investment allocations in the policy result in foreign currency exposure risk. Staff's recommended policy revisions provide for appropriate foreign currency hedging strategies in order to mitigate the foreign currency exposure risk. Please see related agenda item 5.c. for Staff's recommendation of proposed revisions.

Non Core Portfolio – International Investment

Staff recommends expanding the allocation range for Non Core Portfolio International real estate investment per below evaluation.

- An expanded Non Core International allocation will allow Staff continued flexibility to react to the relative global market conditions and opportunities.
- In conjunction with the Real Estate Unit's strategic objective to achieve alpha, Staff seeks additional exposure to the Non Core International real

estate investment markets which may offer more attractive market opportunities relative to the domestic U.S. markets.

- Participation in the Non Core International real estate investment markets offers the potential to obtain increased returns from higher growth economies.
- Exposure to the Non-Core International real estate markets provides diversification opportunities.
- The additional Non-Core International investment may potentially be accretive to the existing Non Core portfolio.

Staff recognizes the risk inherent in Non Core International investments for the Total Equity Real Estate Portfolio per below mitigations to risk.

- The expected returns for investing in Non Core International real estate investment markets incorporate the appropriate risk premiums.
- Only countries on CalPERS' Permissible Equity Markets List will be included in Non Core International real estate investment. With the exception of commingled funds which contain strategies to invest up to 25% of the fund in countries not included on CalPERS' Permissible Equity Markets List.
- Geographic diversification limits for investment in any one country will be required.
- Non Core International real estate investments will be required to be consistent with the International Equity Real Estate Policy.
- Non Core International real estate investments will utilize hedging strategies, if appropriate.
- The Real Estate Unit's SIO and the Board's Real Estate Consultant will approve Non Core International real estate investments.
- Staff is committed to the prudent monitoring of the overall risk profile of the Non Core International investments included in the Total Equity Real Estate Portfolio. Staff will implement measurement practices to ensure appropriate risk adjusted returns and diversification, such as, ongoing evaluation of foreign country risk exposures and risk premiums.

Summary of Proposed Policy Revisions

- A maximum limitation of 25% on Non Core International real estate investments as a percentage of the Total Equity Real Estate Portfolio.
- A maximum limitation of 10% on Non Core International real estate investments in any one international country as a percentage of the Total Equity Real Estate Portfolio.
- A maximum limitation of 25% on total investment for the combined allocation range of the Enhanced Core PREES and Global PREES portfolios as a percentage of the total Equity Real Estate Portfolio and allow for international (non U.S.) investment for the Global PREES portfolio.

- A maximum limitation of 50% on Total Equity Real Estate Portfolio (Core and Non Core) International real estate investments as a percentage of the Total Equity Real Estate Portfolio.
- Allow investment in commingled funds which contain strategies to invest up to 25% of the fund in countries not included on CalPERS' Permissible Equity Markets list.

In conclusion, Staff recommends the Investment Committee's approval of the revised Statement of Investment Policy for Equity Real Estate based on Staff's above evaluation.

See attachment 1 for a schedule of the actual and unfunded allocation ranges compared to the current and proposed policy allocation ranges.

See attachment 2 for letter of concurrence from the Board's Real Estate Consultant, Pension Consulting Alliance (PCA).

See attachment 3 for the blackline revisions to the Equity Real Estate Policy.

Staff and PCA will be available to respond to any questions of the Committee.

V. STRATEGIC PLAN:

This item supports Goal IV to assure that sufficient funds are available, first to pay benefits and, second to minimize and stabilize employer contributions.

VI. RESULTS/COSTS:

This change will clarify existing policy making it more reflective of portfolio preferences and market practices while providing flexibility in a few areas and enhancing portfolio activity within affected real estate portfolios.

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